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Recommendations for amendments to the internal revenue code, submitted to the Committee on Ways and Means, House of Representatives, July 1967

American Institute of Certified Public Accountants. Committee on Federal Taxation

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COMMITTEE ON FEDERAL TAXATION • AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
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FOREWORD *With the passage of time the Federal income tax structure becomes increasingly complex. What, if anything, can be done to simplify it?*

Complexity is inevitable if taxation is to be equitable, if it is to be an economic and fiscal tool, and if it is also to be the means of raising revenues. Nevertheless, to cease striving for simplification would be to adopt a defeatist attitude which might lead to a weakening of the self-assessment income tax system.

For many years, the Committee on Federal Taxation of the American Institute of Certified Public Accountants has sought to improve the income tax law within the existing statutory framework. Having in mind the objectives of equity, simplicity and revenue, the Committee is recommending changes in the Internal Revenue Code to clarify and simplify complex provisions, to eliminate outdated sections, and to remove inequities.

This document lists the Committee's current recommendations for amendments to the Internal Revenue Code.

While the Committee believes that all the recommendations are important and should be adopted, it is only realistic to recognize that adoption of all the suggestions may not be possible at this time. However, the Committee believes that the following recommendations deserve particular attention now because of their effect on business growth, labor mobility and the correction of inequities:

Application of "Overnight Rule" for Meal Expenses—No. 5

Amortization of Intangible Assets—No. 10

Elective Treatment of Trademark and Trade Name Expenditures—No. 13

Deduction for Preliminary Investigation of Business or Investment Opportunities—No. 14

Deduction for Moving Expenses—No. 15

Deductions for Expenditures of Organization and Reorganization—No. 17

Exchanges Involving Foreign Corporations—No. 40

Mitigation of Statute of Limitations in Related Taxpayer Cases —No. 55

The recommendations in this document and earlier ones seek to improve the existing tax structure. In addition, we urge consideration of alternatives to the present tax system. As in the past, we suggest that the best approach would be to establish a nonpartisan commission to study the tax structure and to develop recommendations for basic reform.

The Committee welcomes comments and inquiries.

Committee on Federal Taxation
American Institute of Certified Public Accountants

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Corporate Distributions and Adjustments

For convenience, the recommendations are listed by Code section in the Contents and by subject in the Index.

DETERMINATION OF TAXABLE INCOME

SECTION 47 (a) (1)

1. Certain Dispositions, etc., of Section 38 Property

An additional investment credit should be allowed where the life in actual use proves to be longer than originally estimated.

Section 47(a)(1) provides for a recomputation of the investment credit, with a corresponding increase in tax in the current taxable year, if property is disposed of, or otherwise ceases to be Section 38 property, before the expiration of the useful life which was originally taken into account in computing the credit.

A similar recomputation should be permitted to provide additional credit where property originally estimated to have a useful life of less than eight years is actually held longer than anticipated.

The additional credit should be allowed in the taxable year in which the property achieves an actual life sufficiently long to support a credit greater than that originally claimed. Thus, no statute of limitations problems would arise from retroactive credit adjustments and additional credits would be treated consistently with "recaptured" credits arising from premature dispositions.

SECTION 47 (c)

2. Certain Dispositions, etc., of Section 38 Property

The amount of investment credit recapture for a particular tax year should be offset against the amount of investment credit earned for that year.

Section 47(c) presently provides that the increase in tax resulting from premature disposition of Section 38 property shall not be treated as a tax for purposes of determining the amount of any of the credits allowable under Sections 31 through 39. Since the investment credit is allowed under Section 38, the tax resulting from a recapture cannot be considered as a tax for purposes of calculating the maximum amount of investment credit which may be used currently. Thus, if a corporation has so little taxable income for a taxable year that it cannot use all of its investment credit for that year, it nevertheless might still have to pay a tax as a result of an investment credit recapture which is less than its unused investment credit. Through operation of the carryback and carryforward provisions of Section 46(b), the taxpayer may ultimately receive full credit for the amount of investment credit to which it is entitled, net of recapture. The proposed change would simplify and make certain the achievement of this result, and at the same time provide a treatment both more equitable and more comprehensible to taxpayers.

SECTION 61 (a) (1)

3. Compensation for Services

Such items as commissions earned by an insurance agent on policies on his own life and real estate commissions received by a salesman on a purchase of real estate for his own account represent a reduction in cost and should not be treated as compensation for services rendered.

In *Sol Minzer* v. *Commissioner,* 279 F. 2d 338, it was held that a broker's commission on policies on his own life was income to him and in *Kenneth W. Daehler* v. *Commissioner,* 281 F. 2d 823, it was held that the commission received by a salesman on real estate purchased for his own account was compensation for services.

No economic income can be derived from services rendered to one's self and, therefore, no taxable income should arise.

4. Deduction for Expenses in Securing Employment

Individual taxpayers should be allowed to deduct expenses under Section 162 which are directly related to securing specific employment, whether or not employment is actually obtained.

There are two aspects of this problem: first, the deductibility of the expenses of securing specific employment and, second, the section under which the expenses should be deductible.

The deductibility question received considerable attention when Revenue Ruling 60-158 (1960-1 CB 140), holding fees paid to employment agencies by employees nondeductible, was published and subsequently revoked by Revenue Ruling 60-223 (1960-1 CB 57). The latter ruling states that IRS "will continue to allow deductions for fees paid to employment agencies for securing employment" but does not mention other expenses in connection with securing employment. The same compelling reasons for the change in the Service's stand with regard to employment agency fees justifies the deductibility of other similar expenses.

When a search for employment is unsuccessful, the expenses should also be made specifically deductible. (See *Francois Louis,* TC Memo, 1966-204, which holds that employment agency fees incurred in an unsuccessful employment search were not deductible.) The economic status of an unemployed taxpayer is usually at a low point. It is equitable that expenses incurred in seeking employment at such a time be deductible.

Expenses incurred in connection with the search for employment are within the concept of business expenses of Section 162 and should be so treated. In Revenue Ruling 55-600 (1955-2 CB 576) the IRS expressed this concept by saying, "Salaries and fees received by a taxpayer as compensation for services rendered represent income from a trade or business. . . ." This ruling followed the Tax Court's decision in *Joe B. Luton,* 18 TC 1153.

SECTION 162 (a) (2)

5. Application of "Overnight Rule" for Meal Expenses

A deduction should be allowed for meal expenses on business trips whether or not the taxpayer is away from home overnight.

Section 162 permits a deduction for meal expenses while away from home on business trips. The Internal Revenue Service has consistently disallowed such expenses unless the taxpayer is away from home overnight except where business needs require that rest be obtained during released time.

On the other hand, the courts have not supported the IRS, stating in effect that the word "overnight" does not appear in the Code, and therefore, has no application.

As a result, only those taxpayers willing to litigate are getting this deduction. Legislation should be enacted to make it clear that the taxpayer is not required to be away from home overnight.

SECTIONS 163, 317 AND 1371

6. Definition of Debt Securities

To eliminate existing uncertainties, it is recommended that a statutory provision be enacted defining "debt securities" and outlining specific terms that, if met by a particular instrument, will clearly result in its being treated as bona fide indebtedness for all purposes of the Internal Revenue Code.

One of the more confusing and most litigated areas of taxation involves the question of determining whether a particular instrument, evidencing so-called indebtedness, will be treated for tax purposes as true indebtedness or as equity capital. This determination is important in ascertaining the deductibility of interest payments, the status of payments on principal, the qualification of a corporation under Subchapter S, and in other areas of taxation.

To eliminate some of the uncertainties in this area, specific statutory guidelines should be established to be used in determining whether a particular instrument will be treated as debt or equity. Toward this end, it is proposed that "debt" include any unconditional obligation to pay on demand or on a specified date a sum certain in money, where the obligation is not subordinated to trade creditors generally, where ultimate payment is not expressly contingent upon earnings, and where the principal amount of such obligations held by shareholders does not exceed by more than ten to one the fair value of stock held by shareholders immediately after the obligations are issued. If the taxpayer failed to meet these specific requirements, he would still have the right to establish by a preponderance of the evidence that the obligation is debt rather than equity.

Statutory guidelines of this type would eliminate much uncertainty that now exists in this area and would reduce unnecessary controversy between taxpayers and the Internal Revenue Service.

SECTION 165 (g) (3) (A)

7. Worthless Securities in Affiliated Corporation

An ordinary deduction should be permitted with respect to worthless securities in any corporation in which the degree of ownership required for consolidated returns exists.

Present law provides a deduction for worthless securities in an affiliated corporation in which at least 95 per cent of each class of stock is owned directly by the taxpayer corporation.

This provision dates back to a provision enacted in 1942. In Report No. 1631 (77th Congress, 2nd Session) the Senate Committee on Finance stated that this provision would permit such losses to be taken in full as an ordinary deduction by the parent corporation if it owned directly 95 per cent of each class of stock of the subsidiary. The Report further states that: "Such a parent and subsidiary corporation may file consolidated returns and to this extent the corporate entity is ignored. Thus, the losses of the one may be offset against the income of the other. It is deemed desirable and equitable, therefore, to allow the parent corporation to take in full the losses attributable to the complete worthlessness of the investment in the subsidiary." At that time the law required the ownership of 95 per cent of stock for the filing of a consolidated return.

The Internal Revenue Code of 1954 reduced the percentage of ownership required for the filing of a consolidated return to 80 per cent.

To be consistent with the premise on which the worthless security provision was originally enacted, Section 165(g)(3)(A) should be amended to reduce the required percentage of ownership of stock from 95 per cent to 80 per cent, and the percentage ownership requirement should relate only to stock other than preferred stock which is nonvoting and limited as to dividends.

SECTION 166 (f)

8. Bad Debt Deduction for Guarantor of Corporate Obligations and for Lenders of Business Loans

Section 166(f) should be amended to provide uniformity of treatment in the deduction of a bad debt regardless of whether one or more of the parties to the transaction giving rise to the debt is incorporated or unincorporated or whether the taxpayer is a direct lender or guarantor.

The payment by a noncorporate guarantor, endorser or indemnitor of a noncorporate debt in discharge of his obligation qualifies as an ordinary deduction if the proceeds of the loan were used in the trade or business of the borrower. In *Max Putnam* v. *U.S.*, 352 U.S. 82, the Supreme Court held that a payment by an individual in discharge of his obligation as guarantor of a corporate debt constituted a nonbusiness bad debt deductible only as a short-term capital loss. Furthermore, a noncorporate lender, not in the business of lending money, who lends directly to a corporate or noncorporate borrower when the funds are used in the borrower's trade or business is limited to short-term capital loss treatment for bad debts arising from such loans.

To eliminate these inconsistencies ordinary deductions should be allowed alike to noncorporate lenders, guarantors, endorsers or indemnitors regardless of whether the borrower is corporate or noncorporate, as long as the proceeds of the loan were used in the borrower's trade or business.

SECTION 167

9. Depreciation of Leasehold Improvements

Leasehold improvements should be considered depreciable property even though the estimated economic life of the property is longer than the term of the lease.

Under the provisions of Section 167, taxpayers are permitted various accelerated methods of depreciation providing the asset is property used in the trade or business of the taxpayer or property held for the production of income. On the other hand, amortization deductions under

Section 162 are only allowable in equal annual amounts over the life of the lease.

Regulations Section 1.167(a)(4) indicates that capital expenditures for improvements on leased property are recoverable through allowances for either depreciation or amortization. If the useful life of the improvements is equal to or shorter than the remaining period of the lease, the allowances take the form of depreciation under Section 167. Where the useful life of the improvements is longer than the term of the lease, Regulations Section 1.162-11(b)(1) provides that an annual amortization deduction is allowed which is equal to the total cost of the improvements divided by the number of years remaining in the term of the lease.

The Supreme Court has held in *Hertz Corporation,* 364 U.S. 122, and *Massey Motors, Inc.,* 364 U.S. 92, that for purposes of depreciation "useful life" is the period over which the assets may reasonably be expected to be useful to the taxpayer in *his* trade or business, and not the period of the economic life of the assets. If a taxpayer has made improvements on leased property where the term of the lease is shorter than the economic life of the improvements, the useful life to that taxpayer is the term of the lease. This taxpayer should therefore be entitled to an accelerated depreciation deduction and not be restricted to straight-line amortization. In determining the term of the lease, Section 178 would, of course, be applicable.

SECTIONS 167
177
248

10. Amortization of Intangible Assets

The cost of purchased goodwill, trademarks, trade names, secret processes, formulae, licenses, and similar intangible assets should be amortizable over a stated period to be fixed by statute to the extent that such items are not otherwise deductible under other sections of the Internal Revenue Code.

When intangible assets, such as those described in the headnote are *developed* by a taxpayer, the costs:

1. May be deducted as paid or incurred, or at the election of the taxpayer, amortized over a period of not less than 60 months if the

expenditures are research and experimental expenditures (Section 174).
2. May be amortized over a period of not less than 60 months if the expenditures are in connection with a trademark or trade name (Section 177).

It is inequitable to treat the costs of intangible assets purchased by a taxpayer differently from those incurred in the development of intangible assets. A taxpayer who purchases an intangible asset of a type listed in the headnote can amortize its cost only if a definitely determinable life can be established for it or, failing that, upon proof of abandonment of the asset.

For various reasons it may be difficult or impossible to demonstrate with reasonable certainty either a definitely determinable life or abandonment. The difficulty is complicated further where the value of intangible assets is subject to erosion from various causes, such as changes in technology, obsolescence, changes in public buying habits, deterioration of business conditions in geographic areas, or other shifts in social and business habits. Many court decisions and IRS rulings have held that no amortization is allowable in these circumstances because the total useful life of the intangible asset cannot be estimated, even though its value obviously was impaired.

The House Ways and Means Committee Report (Report No. 1337, 83rd Congress, 2nd Session) which accompanied H.R.8300 stated that one of the reasons for the enactment of Section 174 was to "eliminate uncertainty and to encourage taxpayers to carry on research and experimentation." Equally important reasons exist for encouraging the mobility of capital by providing that taxpayers who purchase intangible assets (which resulted, in most instances, from expenditures by the seller which were deductible under Section 174 or 177) should be permitted to amortize those costs over a reasonable period of time.

The Code should be amended to provide that the cost of all purchased intangible assets such as those listed in the headnote should be amortizable:

1. Over the actual life of the intangible asset if a definite life can be determined; or
2. If a definite life cannot be determined, over a period of 120 months or, at the election of the taxpayer, a longer period.

Section 1245 should provide, if it does not now do so, for recapture of amortization claimed when the intangible assets are sold or otherwise disposed of in a transaction covered by Section 1245.

SECTIONS
167
611
642

11. Depreciation and Depletion—Estates

Allocation of the deduction for depreciation and depletion should be made according to distributable net income only where allocation is not provided by the will or local law.

In the case of an estate, the allowable deductions for depreciation and depletion are apportioned between the estate and the heirs, legatees and devisees on the basis of the income of the estate allocable to each, regardless of any provisions to the contrary in the will or local law. This requirement does not seem reasonable and should be amended so it will apply only where no allocation is provided by the will or local law. Moreover, the suggested change would conform the rules for estates to those applicable to trusts.

SECTION
172 (d) (4) (D)

12. H.R. 10 Plan Contributions: Self-Employed Individuals

This section provides that a deduction, otherwise allowable, for contributions to an H.R. 10 plan for the benefit of self-employed individuals and owner-employees is not to be treated as being applicable to the trade or business of the individual for purposes of computing a net operating loss. This is an unwarranted restriction on the deductibility of such a contribution and should be eliminated.

Section 172 establishes the rules for computing the amount of operating loss, operating loss deduction, and operating loss carryback or carryover. Operating loss is defined as the excess of the deductions allowed by Chapter 1, with certain exceptions, over the gross income. One exception for an individual is that expenses which are not attributable to the taxpayer's trade or business are allowed only to the extent that the taxpayer has gross income not derived from such trade or business.

The statute now provides (Section 172(d)(4)(D)) that contributions to an H.R. 10 plan on behalf of self-employed individuals and owner-employees are deemed not to be attributable to a trade or business for purposes of computing a net operating loss.

Assume the situation of a taxpayer who conducted two separate businesses, the first having an H.R. 10 plan and which operated at a profit in 1965, after a contribution to the H.R. 10 plan, and the second operated at a loss larger than the profit from the first business. In computing the net operating loss for 1965, to determine the amount which might be carried back to prior years, the contribution to the H.R. 10 plan for the benefit of the owner-employee would not be an allowable deduction unless the taxpayer had nonbusiness income, such as dividends, in an amount equal to his H.R. 10 plan contribution plus all other nonbusiness deductions.

The contribution to the H.R. 10 plan in such a case is an expense of the taxpayer's trade or business and should be so treated for purposes of determining the net operating loss deduction.

SECTION 177

13. Elective Treatment of Trademark and Trade Name Expenditures

Trademark or trade name expenditures should be deductible merely by claiming the expenditures as a deduction in the tax return for the year paid or incurred. At the election of the taxpayer, such expenditures would, alternatively, be capitalized and amortized over a period not less than 60 months.

Section 177 provides that at the election of the taxpayer any trademark or trade name expenditure may be treated as a deferred expense and amortized over a period of not less than sixty months. If this election is not made the item is capitalized.

Section 177 and the regulations thereunder require that the items to which the election to defer and amortize applies must be specifically itemized and identified in an election filed with the return. This requirement creates problems because the election may be overlooked where items are not identified in the accounts to indicate that they are subject to deferral and amortization. For example, defense of a trademark may be carried on by the taxpayer's regular counsel and the related legal expense may not be indicated in the invoices from the attorney. Thus, the election to amortize the trademark defense costs may be overlooked.

In order to allow taxpayers the intended benefit of this provision, it is recommended that Section 177 be amended to conform to Section 174 so that expenditures for trade names and trademarks would be allowed as a deduction in the year in which paid or incurred or, at the election of the taxpayer, capitalized and amortized over a period of not less than 60 months.

SECTION 212

14. Deduction for Preliminary Investigation of Business or Investment Opportunities

Losses sustained by an individual during a taxable year with respect to expenditures incurred in search of a prospective business or investment should be deductible regardless of whether the proposed transaction was consummated.

Prior to 1957 the Internal Revenue Service followed I.T. 1505 (I-2 CB 112) in permitting a deduction for expenses incurred in determining whether or not an investment should be made. The ruling held that such an investigation constituted a transaction entered into for profit and that upon abandonment of the enterprise the expenses incurred became a loss deductible in the year of abandonment.

I.T. 1505 was based upon Section 214(a)(5) of the Revenue Act of 1921 and the related regulations. This section of the 1921 Act corresponds to Section 165(c)(2) of the Internal Revenue Code of 1954, which allows a deduction by individuals for "losses incurred in any transaction entered into for profit, though not connected with a trade or business. . . ."

Revenue Ruling 57-418 (1957-2 CB 143), after reviewing the history of the application of the rule, revoked I.T. 1505 and established a new rule that "a loss sustained during a taxable year with respect to expenditures incurred in search of a prospective business or investment is deductible only where the transaction has actually been entered into and the taxpayer abandons the project."

Expenditures made in connection with a preliminary investigation of business or investment opportunities should be deductible even if a taxpayer abandons the prospective project before entering into a material amount of activity in connection with it. Such preliminary expenditures should be equivalent to those which are admittedly deductible where the taxpayer *has* engaged in material activity. See *Charles T. Parker,* 1 TC 709, distinguished by the IRS in Revenue Ruling 57-418 (1957-2 CB 143).

There appears to be no equitable justification for limiting the deduction of investigatory expenses to situations where the prospective transaction was actually entered into and subsequently abandoned. If a taxpayer makes a good faith investigation of a business prospect, which would produce taxable income and tax revenues if successful, then ordinary standards of equity and fair play should permit deduction of expenses in cases where the prospect turns out to be unattractive and is abandoned without further action on the part of the taxpayer. This would be consistent with the basic distinction between deductible and nondeductible expenditures; i.e., whether such expenditures are inherently personal in nature or are intended to promote, *create* or benefit business activity.

SECTION 217

15. Moving Expenses

The definition of moving expenses should be expanded to cover additional out-of-pocket expenses directly related to employee relocations and relocations of the businesses of self-employed persons.

The deduction for moving expenses enacted in the Revenue Act of 1964 should be expanded to improve labor mobility, to relieve the substantial economic burden on employee-taxpayers who relocate and to promote business growth and opportunity.

Specific statutory recognition should be given to additional out-of-pocket costs directly related to employee relocations, including necessary expenditures during a reasonable period of search for housing at the new location and out-of-pocket costs of disposing of and acquiring residential properties. Costs of this nature may present a more serious financial problem to the individual being moved than the transportation expenses of the move.

It should be made clear that any expanded definition of moving expenses applies also to "old" employees who may be reimbursed by their employers.

To facilitate business growth and opportunity, a similar deduction should also be allowed to self-employed persons for expenses incident to the moving of their businesses from one location to another.

SECTION 246 (b)

16. Limitations on Deductions for Dividends Received

The limitation on the amount of the dividends received deduction to 85 per cent of taxable income should be amended to allow a deduction of 85 per cent on all dividends received from domestic corporations.

Section 243(a)(1) allows a deduction to a corporation of an amount equal to 85 per cent of the dividends that it receives from domestic corporations, but Section 246(b)(1) limits the 85 per cent deduction to 85 per cent of taxable income. Section 246(b)(2) provides that the limitation in Section 246(b)(1) does not apply for any taxable year for which there is a net operating loss. The limitations imposed on the dividends received deduction by Sections 246(b)(1) and (2) cause needless complexity and sometimes provide an illogical result when the existence of an insignificant amount of net operating income causes a substantial curtailment in the dividends received deduction which would not have occurred if a net operating loss (no matter how small) had existed.

The Revenue Act of 1964 amended the Code to allow a 100 per cent deduction in the case of qualifying dividends received (from related companies), and the 2 per cent tax applicable to consolidated income tax returns was repealed. These amendments should facilitate the free flow of funds between related corporations. Elimination of the limitation on the 85 per cent dividends received deductions provided in Sections 246(b)(1) and (2) would improve the situation further.

SECTION 248

17. Deductions for Expenditures of Organization and Reorganization

Organizational expenses should be allowed as an amortizable deduction free of any election and the deduction should be expanded to cover reorganization expenses (including stock dividends and stock splits) and registration and stock listing costs.

Section 248(a) provides that organizational expenses may, at the election of the taxpayer, be amortized over a period of not less than 60 months to be selected by the taxpayer. The regulations require that this election be made in the return for the taxable year in which the taxpayer begins business and that all of the expenditures subject to the election be specifically identified.

The election requirement of Section 248(a) constitutes an unnecessary complication of the Code. The deductibility of an item should be determined by the nature of the item rather than upon strict compliance with the requirements of an election. Organizational expenses and expenses of a like or similar nature should be deductible over a period of not less than 60 months free of any election.

In addition to the elimination of a formal election requirement, the deduction under Section 248 should be expanded to cover reorganization expenses, including the cost of stock registration and stock listing and the cost of printing certificates for stock dividends and stock splits. These expenditures are all of like or similar nature to organization expenses, and there should be no statutory distinction between organization and reorganization expenses or between original capitalization expenses and the expense of printing and preparing stock certificates on subsequent stock dividends or stock splits.

SECTION 269

18. Carryover of Operating Losses — Acquisition of New Businesses

It should be made clear that in the absence of a change of ownership of 50 per cent or more of an existing corporation, carryover of operating losses should not be denied merely because of the acquisition of new businesses.

For an explanation of this recommendation refer to the explanation of recommendation number 45 on p. 30.

SECTION 274

19. Deduction of Certain Entertainment, etc., Expenses

Entertainment, amusement and recreation expenses which are ordinary and necessary business expenses should be deductible.

Section 274 should be amended to provide for the deductibility of entertainment, amusement or recreation expenses for both an activity and a facility if they are incurred primarily to further the taxpayer's trade or business, and are not primarily personal, family or living expenses. The taxpayer would be required to substantiate such expenses by adequate records or other sufficient evidence.

CORPORATE DISTRIBUTIONS AND ADJUSTMENTS

SECTIONS
301 (b) (1) (B)
301 (d) (2) (B)

20. Recognition of Gain to Distributor Corporation

All gain recognized to a distributor corporation upon the distribution of property to a corporate distributee should be taken into account in determining the amount of the distribution and the basis of the distributed property.

The present statute specifically refers to those sections of the law that provide for recognition of gain to distributor corporations from the distribution of Lifo inventory, properties subject to indebtedness in excess of basis, and gains recognized under Sections 1245 and 1250. It is recommended that the language in Sections 301(b)(1)(B) and 301 (d)(2)(B) be changed to take into account all gain recognized to a distributor corporation, regardless of the particular sections that might create authority for such recognition, and reference to selected sections should be eliminated. For example, the distribution of installment obligations to a corporate distributee, which creates gain recognized under Section 453(d), should also be included under Sections 301(b)(1)(B) and 301(d)(2)(B).

SECTION 302

21. Lost Basis—Redemption of Stock Taxed as Dividend

Basis should not be lost when redemptions of stock are taxed as dividends.

It is recommended that specific statutory provisions be enacted along the following lines:

1. Where the proceeds of stock which is sold or redeemed are taxed as ordinary income, the allocation of basis to other stock held by the taxpayer, if any, should be permitted.
2. If the taxpayer has been taxed on account of direct attribution (through family, partnership, estate, corporation, or trust), the basis of his stock should be allocated to the stock that was the basis of the attribution.
3. The taxpayer to whose stock basis is allocable hereunder should be allowed at least one year from the date of final determination (that a redemption is to be treated as a dividend) to file claim for refund if the statute of limitations would otherwise foreclose that right.
4. With respect to Section 302(c)(2)(A), if during the ten-year period in which the reacquisition rules apply, the taxpayer should acquire an interest in the corporation, provision should be made to prevent the loss of the basis of the stock surrendered in the redemption distribution which is subsequently treated as a dividend.

A taxpayer should not lose tax benefit from the basis of shares surrendered in a redemption transaction that is subsequently treated as a dividend. The statute should clearly state what happens to the basis of stock surrendered in such a transaction and should extend the statute of limitations for filing a refund claim if the taxpayer to whom basis is allocated under the statutory rules would otherwise be deprived of tax benefit. If there is a reacquisition during the ten-year period, the statute of limitations is left open for assessment under present law. Similar protection should be extended for the basis of the stock redeemed.

SECTION 302 (c) (2) (A) (ii)

22. Constructive Ownership of Stock

A person reacquiring stock through bequest or inheritance should be permitted to become a director or officer even though he previously qualified for a redemption under Section 302(c)(2).

So long as the requirements of Section 302(c)(2)(A)(ii) are satisfied at the time required, there appears to be no reason why persons reacquiring stock through bequest or inheritance should not be able to participate in the management of the corporation even though they previously qualified for a redemption under Section 302(c)(2).

SECTION 303 (b) (2) (B)

23. Distributions in Redemption of Stock to Pay Death Taxes

The present provisions of Section 303(b)(2)(B), permitting the benefits of Section 303(a) in situations where the decedent's estate includes stockholdings of two or more corporations, seem unduly restrictive. The percentage of ownership as to the stock of each corporation required in order for the 35-50 per cent tests to apply should be calculated using constructive ownership rules.

This section of the Code now provides for aggregating the values of stock in two or more corporations if the estate owns more than 75 per cent in value of the outstanding stock of each of such corporations. It has recently been held that this test applies only to directly owned stock. Thus it is possible for an estate to own beneficially most of the stock of several corporations and yet not qualify for aggregation of the values, simply because some of the stock might be held by other corporations in the same group. It seems equitable that the constructive ownership rules of Section 318 be applied for determining qualification under Section 303(b)(2)(B). These rules now apply to redemptions under Section 302 and there is no logical reason why they should not also be considered in Section 303 redemptions.

SECTION 304

24. Acquisitions by Related Corporations

1. The present statute seems unclear and possibly conflicting in its wording. It is recommended that in a brother-sister acquisition, even though the constructive ownership rules of Section 318 might indirectly create a parent-subsidiary relationship, the transaction should clearly be governed by Section 304(a)(1) rather than Section 304(a)(2).

2. The statute now provides that, in the case of brother-sister redemptions, the stock acquired is treated as a contribution to capital, regardless of whether the distribution itself is treated as a dividend or as a sale or exchange. It is recommended that the statute be amended to provide contribution to capital treatment only in cases where the distribution is treated as a dividend.

Section 304(a)(1) presently sets out rules for acquisitions of stock by related corporations other than subsidiaries. Section 304(a)(2) provides rules for acquisitions by subsidiaries. Under the constructive ownership rules of Section 318, stock of a sister corporation can be attributed indirectly to the brother corporation, or vice versa, thereby creating indirectly a parent-subsidiary relationship. A literal interpretation might then require that this type of acquisition (brother-sister) be construed under the provisions of Section 304(a)(2) rather than 304(a)(1). Since there is some difference in treatment under the sections, the statute should be amended to state clearly that acquisitions in brother-sister situations be governed solely by Section 304(a)(1).

Section 304(a)(1) now provides that stock acquired in an acquisition governed by its terms shall be treated as having been transferred by the person from whom acquired, and as having been received by the corporation acquiring it, as a contribution to the capital of such corporation. Apparently, this rule applies regardless of the tax treatment of the acquisition to the shareholder. The rule should apply only to situations where the distribution is treated as a dividend. Where the acquisition is treated as a sale or exchange, it seems more logical and equitable that the acquiring company's basis be equal to the amount paid by it for the stock.

SECTION
332 (c) (2)

25. Satisfaction of Indebtedness of Subsidiary to Parent

The rule now stated in this section regarding the satisfaction of indebtedness of a subsidiary to its parent should be amended to provide nonrecognition of gain or loss to the distributing corporation by virtue of distributions of property and discharge of indebtedness created after adoption of the plan of liquidation.

Present law provides only for nonrecognition of gain or loss as to distributions of property in satisfaction of indebtedness existing on the date of adoption of the plan of liquidation. Occasionally, it may be necessary to create similar indebtedness after a plan of liquidation is adopted but before the liquidation is completed. There appears to be no logical reason why the nonrecognition rule should not also apply to distributions of property in satisfaction of this type of indebtedness.

SECTIONS
333 (e) (2)
333 (f) (1)

26. Liquidating Distributions Acquired Before December 31, 1953

The cut-off date with respect to the acquisition of stock or securities distributed by a corporation liquidating under Section 333 should be revised.

In determining the amount of realized gain that is to be recognized by a shareholder in a Section 333 liquidation, present law provides that realized gain may be recognized to the extent that the shareholder receives money or stock or securities acquired by the liquidating corporation after December 31, 1953. Originally, this cut-off date was necessary in order to prevent the investment of cash in stock or securities in anticipation of a liquidation under Section 333. The date is now unrealistic. The statute should be changed to fix a cut-off date five years prior to the date on which the corporation adopts its liquidation plan.

During the 1st Session of the 90th Congress, Senator Magnuson introduced S. 614 and Representative Adams introduced H.R. 185 to accomplish the objectives of this recommendation.

SECTION 334

27. Basis of Property Received in Liquidations

Uncertainty exists regarding the term "cash and its equivalent" as used in Regulations Section 1.334-1(c)(4). The phrase should be defined by statute in order to simplify the determination of basis to be allocated to assets received in corporate liquidations.

Because of uncertainty resulting from administrative practice and the regulations under Section 334, Congress should establish statutory meaning for the term "cash and its equivalent" as used in allocating basis to assets received in corporate liquidation. In Revenue Ruling 66-290 (IRB-1966-40, 8), the IRS applied the term to certificates of deposit and savings and loan association accounts, as well as cash deposits. The ruling stated, however, that the term does not include accounts receivable, inventories, marketable securities, and other similar current assets.

The interpretation placed on the term "cash and its equivalent" by the IRS seems unduly restrictive and statutory guidelines for taxpayers are most desirable. The basic concept that should apply is the liquidity of the particular assets involved and whether or not they can be converted to cash in a short period of time. Certainly, marketable securities meet this test and should be included within the meaning of the term. In most cases, trade accounts receivable will be converted into cash in a relatively short period of time and should be similarly treated.

Section 334(b)(2) is automatic rather than elective for subsidiaries that are liquidated within a two-year period, and taxpayers presently have little guidance as to the allocation of basis to assets received in such liquidations.

SECTION 336

28. Effect on Liquidating Corporation of Distribution of Property in Liquidation

Section 336 presently provides that no gain or loss be recognized to corporations upon their liquidation. The section should be amended to conform to the provisions of Sections 47, 1245 and 1250, which do provide for the recognition of gain under certain limited circumstances in corporate *liquidation transactions.*

Due to the fairly recent enactment of Sections 1245 and 1250, under certain conditions, gain will be recognized to the distributing corporation on distributions of property in partial or complete liquidation. This seems directly contrary to the present language of Section 336. It is recommended that Section 336 be amended so as to set out clearly situations where gain will be recognized. Furthermore, some reference should be made to Section 47, covering the recapture of the investment tax credit with respect to certain distributions of Section 38 property. The basic thrust of this recommendation is directed toward clarifying Section 336 so that in addition to its stating the general rule for taxing the distributing corporation on distributions of property in liquidation, it will clearly state the exceptions to that rule.

SECTION 337 (a)

29. Gain or Loss on Sales or Exchanges in Certain Types of Liquidations

Section 337(a) should be amended to include involuntary conversions within the definition of "sale or exchange."

This section should be amended to specifically include all involuntary conversions within the definition of sale or exchange. In Revenue Ruling 64-100 (1964-1 CB 130), the Internal Revenue Service held that an involuntary conversion resulting from complete destruction by fire or explosion constituted a sale for purposes of Section 337(a), but it has not yet included condemnation awards. All types of involuntary conversions should be treated as a sale for purposes of Section 337.

Furthermore, in connection with any involuntary conversion, the taxpayer should be given a minimum period of 60 days after occurrence of the event within which to adopt a plan of liquidation and obtain the provisions of Section 337.

SECTION 337 (c) (1) (A)

30. Collapsible Corporations — Application of Section 337

The nonrecognition provisions of Section 337 should apply to sales made by an otherwise collapsible corporation if any of the limitations of Section 341(d) would prevent the application of Section 341(a) to all of the shareholders of such corporation.

At the present time the benefits of Section 337 are denied to a *corporation* which falls within the general definition of a collapsible corporation as prescribed by Section 341(b). This is true even though the limitations contained in Section 341(d) may prevent the application of Section 341(a), the operative portion of the section, to any of the *shareholders.* There is no logical reason for prohibiting Section 337 treatment in any case where Section 341 is inoperative. Section 337 (c)(1)(A) should be amended to eliminate this defect and, at the same time, to refer to the special provisions of Section 341(e)(4).

SECTION 337 (c) (2)

31. Liquidation of Subsidiaries in Section 337 Transactions

Section 337 should be amended to include the liquidation of subsidiaries within the benefits of Section 337, if both subsidiaries and their parent are liquidated within the twelve-month period now provided.

As now worded, Section 337(c)(2)(A) denies the benefits of Section 337 in certain parent-subsidiary situations where the subsidiary is liquidated into the parent during the twelve-month period required by Section 337(a)(2) and Sections 332 and 334(b)(1) apply to the liquidation. Under present rules there are available several indirect ways to avoid this result (e.g., liquidate the subsidiary prior to having the parent adopt its plan of liquidation). However, to meet this problem directly an amendment to Section 337(c)(2) is necessary.

The amendment should extend nonrecognition treatment under Section 337 to the liquidation of a subsidiary if the subsidiary and its parent are liquidated within the twelve-month period beginning on the first date of adoption of a plan of liquidation by the subsidiary or the parent.

SECTION 341 (a)

32. Treatment of Short-Term Gain

The literal language of this section makes it applicable only to gain that would otherwise be treated as long-term capital gain were it not for the holding period. It is recommended that gain on sale or exchange

of all collapsible corporation stock be treated as gain from the sale or exchange of property not a capital asset, regardless of the holding period.

In the event of the sale of, distribution in partial or complete liquidation of, or related distribution with respect to stock held for six months or less, present language would provide that the gain be considered as capital gain even though the corporation was collapsible. Under these circumstances, capital losses could be applied to offset such gain. This does not appear to be consistent with the intent of the collapsible corporation provisions.

SECTIONS
341 (a)
341 (d)

33. Convertible Bonds, Warrants and Options as Stock

In applying Section 341, convertible bonds and options and warrants to acquire stock should be treated as stock.

If convertible bonds, warrants or options are "securities" convertible into stock of a collapsible corporation, the gain realized from their disposition should be treated in the same way as gain from the disposition of the stock into which they are convertible.

SECTION
341 (d) (2)

34. Clarification of Over-70 Per Cent Test

The extent to which "gain is attributable to the property" for purposes of the over-70 per cent limitation test should be clarified.

Realization on sale of Section 341 assets in prior years or in the current year up to the date of sale or redemption or distribution in partial or complete liquidation should not be treated as collapsible asset gain. If the corporation has paid or will pay tax on gain realized on previous sales of collapsible assets, it is inequitable to continue to treat the gain as collapsible asset gain.

SECTION 341 (f)

35. Certain Sales of Stock of Consenting Corporations

Section 341 should be amended to protect the shareholder who purchases stock in a corporation which has consented to the treatment provided in Section 341(f) where, subsequent to such purchase, it is determined that the corporation was not in fact a collapsible corporation.

This subsection was enacted in August, 1964 to provide some relief in connection with sales of stock of corporations which might, at the time the stock sale occurs, be collapsible corporations. This subsection should be amended to provide that the election will not be effective if the corporation is determined not to have been collapsible at the time the sale of stock occurred which necessitated the election. This would prevent an election made out of a superabundance of caution from trapping an unwary purchaser of the stock who had nothing to do with making the election in the first place.

SECTION 351

36. Securities Received in Exchange

The nonrecognition provisions of Section 351 extend to transfers of property to a corporation solely in exchange for stock or "securities" in such corporation. The term "securities" should be defined by statute to include a note, bond or other evidence of indebtedness with a maturity of five years or more.

One of the problem areas under Section 351, in view of divergent court decisions, is to determine the meaning of the term "securities." A statutory definition is necessary to provide guidance to taxpayers and eliminate unnecessary conflict. The definition should provide that a note, bond, or other evidence of indebtedness with a maturity of five years or more would qualify as a security under Section 351.

SECTIONS 351, 355 AND 368 (c)

37. Control

Legislation is needed to clarify a conflict existing between the statutory definition of corporate control for purposes of Sections 351, 355 and 368(c) and that contained in Revenue Ruling 59-259.

For purposes of these sections, control is defined (Section 368(c)) as "the ownership of stock possessing at least 80 per cent of the total combined voting power of all classes of stock entitled to vote and at least 80 per cent of the total number of shares of all other classes of stock of the corporation."

Revenue Ruling 59-259 (1959-2 CB 115) interprets the above definition to require ownership of at least 80 per cent of the total number of shares of *each* class of outstanding nonvoting stock. The language of the Code should be corrected if this ruling properly reflects Congressional intent.

SECTION 356 (a) (2)

38. Treatment of "Boot"

Section 356(a)(2) as presently worded should be eliminated and replaced by provisions that would:

1. **Treat as a dividend for all purposes of the Code any distribution of "boot" which has the effect of the distribution of a dividend within the principles of Section 301,**
2. **Treat as a partial liquidation under Section 346 such part of the "boot" received which has that effect, and**
3. **Treat as a redemption of stock under Section 302 such part of the receipt of "boot" which has that effect, determined by reference only to stockholdings of the shareholders of the acquired corporation immediately prior to the reorganization.**

With few exceptions, the courts and the Internal Revenue Service have treated the "boot" provisions of Section 356(a) as requiring that any gain attributable to the "boot" first be treated as a dividend to the receiving shareholder to the extent of accumulated earnings and profits. Only the balance of any gain then results in capital gain. There is no sound reason for the apparent inconsistency between Section 356(a)(2) on one hand and Sections 301, 302 and 346 on the other. It is difficult to justify the different language under Section 356, based upon accumulated earnings and profits, rather than first out of current earnings and profits, as under Section 301. It is equally difficult to justify the requirement that the distribution of "boot" in every reorganization will always result in dividend income unless the distributing corporation has a deficit, without regard to whether or not the shareholder has in substance received a distribution in partial liquidation or a distribution arising from a disproportionate redemption of some of his shares.

SECTION 362 (b)

39. Basis to the Acquiring Corporation of Stock Received in a B-Type Reorganization

The determination of basis of the acquired company's stock in a B-type reorganization should be simplified in a manner similar to that in a C-type reorganization.

It is often quite difficult to obtain the basis for the acquired company's stock in a B-type reorganization, particularly where it is widely held. To overcome this problem, the Code should be amended to provide that where in a B-type reorganization 80 per cent or more of the stock of the acquired company is acquired during a twelve-month period, a substituted basis for the stock acquired should be allowed equal to the excess of the basis of the assets in the hands of the corporation being acquired over its liabilities, just as if there had been a C-type reorganization. This would place the transaction in a similar position to a C-type reorganization and should simplify operation of the statute.

40. Foreign Corporations

The Secretary of the Treasury or his delegate should be given statutory authority to make a determination, after an exchange, that such exchange was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

Section 367 provides that in determining the extent to which gain shall be recognized in the case of any of the exchanges described in Sections 332, 351, 354, 355, 356, 361, a foreign corporation shall not be considered as a corporation unless, *before* such exchange, it has been established to the satisfaction of the Secretary or his delegate that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

Sections 1491 and 1492, enacted at the same time and for a similar purpose, provide that an excise tax of 27½ per cent shall be imposed on transfers of stock or securities to a foreign corporation unless, *before* such transfer, it has been established to the satisfaction of the Secretary or his delegate that such transfer is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

Notwithstanding the similarity of purpose and structure of these sections, Section 1494(b) provides that the tax otherwise imposed by Section 1491 may be abated, remitted or refunded if *after* the transfer it has been established to the satisfaction of the Secretary or his delegate that the prescribed tax avoidance purpose did not exist. The legislative history discloses no reason for withholding similar relief from the impact of Section 367, which has been and continues to be a trap for the unwary.

To correct this situation it is suggested that the first sentence of Section 367 be amended as follows:

"In determining the extent to which gain shall be recognized in the case of any of the exchanges described in Section 332, 351, 354, 355, 356 or 361, a foreign corporation shall not be considered a corporation unless it is established that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes."

SECTION
368 (a) (1) (B)

41. B-Type Reorganizations — Exchange of Cash

In an exchange of stock for stock in a B-type reorganization, the issuance by the transferee of cash to avoid fractional shares, or the assumption by the transferee of reorganization expenses or transfer taxes, should not deny qualification for reorganization treatment.

In Revenue Ruling 66-365 (IRB 1966-50, 34), the Internal Revenue Service recognized some court decisions (e.g., *Mills, et al.* v. *Commissioner,* 331 F.2d 321 (1964)) and stated that the "solely for voting stock" requirement is met where the acquiring corporation pays cash in lieu of issuing fractional shares and the cash is not a separately bargained for consideration but merely represents a rounding-off of the fractions. Even as so modified, the rule requiring "solely" voting stock seems too stringent. It should be relaxed to permit limited exchanges of cash or other property for legitimate business purposes and to eliminate doubt as to the qualification of a particular transaction as a reorganization. While some departure from the strict language of the Code has been permitted, a statutory "de minimis" rule should be enacted limiting the amount of cash and other property to perhaps 5 per cent of the total consideration.

SECTION
381 (a)

42. Tax Attributes in Intercorporate Transfers

Inheritance by a successor corporation of the various tax attributes of a predecessor corporation should also apply to intercorporate transfers and to transfers to a subsidiary.

Without this addition to the Code, it may be possible for a corporation to terminate previous adverse elections by transferring all or part of its business to a newly formed corporation which can then make new elections that will be more advantageous in the future.

SECTION 381 (c)

43. Carryovers of Various Tax Attributes

A general provision should be adopted to cover the carryover of tax attributes in certain corporate acquisitions.

Section 381(c) as currently stated contains a long list of specific items of the distributor or transferor corporations that will be "inherited" by distributee or transferee corporations. In the interest of simplification, it is recommended that this lengthy recital of specific items be replaced by a general provision which would be amplified by regulations.

SECTIONS
382
269

44. General Comment — Carryover of Operating Losses

The whole structure of the Internal Revenue Code as it relates to the taxation of corporations and stockholders is founded on the proposition that the corporation is a separate taxable person. In this connection the concept of "continuity of interest" has been understood as justifying recognition of the identity of a corporate person despite certain changes in its structure. If continued recognition of this concept is desirable, and it seems that it is, there does not appear to be any justification for denying access to carryover deductions except where changes of *both* ownership and business result in the creation of a new business person.

Where stockholders have pooled their capital in a corporation for the purpose of engaging in business for profit but have sustained losses, it is illogical to assume that the stockholders should not seek to recoup those losses by improving the operations of the losing business or by engaging in another business which might be more profitable. If the latter course is taken, and a new business is acquired, the operating loss carryovers should be available as though the recovery were from improved operations.

In the absence of a change of ownership sufficient to interrupt the continuity of interest, the continuing tax identity of the corporate person should be recognized. To do otherwise would be to place fiscal expediency ahead of reasonable tax policy.

For the same reasons, continuation of the separate corporate person should be recognized, as at present, when there is a change of ownership but no significant change in business activities.

Where there is a significant change of business activities coupled with a significant change in ownership, the law should recognize that the effect is the same as formation of a completely new taxable person and the carryover of loss deductions in such circumstances should be denied.

Revenue Ruling 63-40 (1963-1 CB 46) is a step in the right direction in that it provides that operating loss carryovers will not be denied in instances in which a new business is acquired and there is *little or no* change in stock. The conclusion is too narrow, however, and does not take care of the other existing inconsistencies in the statutory sections dealing with operating loss carryovers.

With certain modifications, but within the present basic structure of Sections 269 and 382, the foregoing objectives can be attained. The following recommendations are suggested to accomplish that result.

SECTION 269

45. Carryover of Operating Losses — Acquisition of New Businesses

It should be made clear that in the absence of a change of ownership of 50 per cent or more of an existing corporation, carryover of operating losses should not be denied merely because of the acquisition of new businesses.

Revenue Ruling 63-40 (1963-1 CB 46) indicates that if a new business is acquired, and there is little or no change in stock ownership during or after the period in which losses were incurred, the corporation will not be barred from using prior losses against the profits of a newly acquired business. The ruling also states that if there is more than a minor change in stock ownership of a loss corporation which acquires a new business enterprise, the Service may continue to contest the deductibility of the carryover of the corporation's prior losses against the income of the new business enterprise.

It should be made clear that carryover of operating losses against the profits of a newly acquired business should not be denied unless there is a change of 50 per cent or more in the ownership of the company.

SECTION 382

46. Acquisitions Through Reorganizations — Percentage Reduction Rules

The percentage reductions in Section 382(b) applicable in the case of reorganizations of loss companies should be replaced by rules similar to those applicable to purchases under Section 382(a). That is, where shareholders of the loss company do not retain an interest of 50 per cent or more in the continuing company, the operating loss should be denied unless a "continuity of business" test is met. There should also be a provision under which substantially all the assets received from the loss company could be transferred to a subsidiary, if the subsidiary meets the continuity of business test.

There seems to be no basis for distinguishing between a sellout accomplished by means of a taxable transaction and one accomplished by a reorganization even though the selling shareholders retain an interest. In either case the "continuity of business" test should be applied. The alternative of allowing the carryover to remain in a subsidiary is necessary to permit use of the loss against profits from a continuation of the loss corporation's business even though the acquiring corporation has other types of business.

SECTION 382 (a) (1)

47. "Continuity of Business" Test

Where there has been a change in ownership of a loss company, a reasonable but more specific "continuity of business" test should be applied. Expansion of existing lines of products or services, including the acquisition of a business having the same or similar products or services, should be permitted. In addition, the company should be

permitted to develop a natural outgrowth of the existing business provided that the new activity is not a major portion of the whole. The loss company should not be prevented from dropping unprofitable lines or from moving its location or changing its personnel in an effort to earn profits against which it may offset the loss carryover.

The purpose of Section 382(a)(1) is to prevent new owners from acquiring a loss company and using its loss against profits from an unrelated business undertaken under the new management. However, it also prevents new owners from discontinuing or radically changing unprofitable lines of business and hampers normal expansion and diversification of products or services. These effects are unreasonable and undesirable and should be corrected.

A company in the electronic business, for instance, which is manufacturing a device for a specific kind of measurement should be permitted to:

1. Discontinue its manufacture when technological changes make some other device better.
2. Add to its list of products devices for any other kinds of measurement, either by the company's own research and development or through the acquistion of an existing business.

SECTION 382 (a) (1)

48. Period Over Which Changes in Stock Ownership Are Measured

In making a comparison of stock ownership for purposes of Section 382(a), the earlier date should be "twenty-four months before the end of the taxable year."

Section 382(a) provides a period of time over which a change in ownership is measured. This period should be a uniform period, such as twenty-four months, and should not be shortened merely because a taxpayer has a short taxable year. Short years may arise from entering into or withdrawing from a consolidated group or from a change in fiscal year, neither of which should result in a reduction in the period of time for testing changes in stock ownership.

SECTION 382 (a) (1)

49. Limitation on Denial of Net Operating Loss Carryover

The denial of carryover loss should be restricted to losses which occurred before the change in stock ownership and the change in business.

Because of the present wording in Section 382(a)(1)(A)(ii), if there were a change in ownership and a change in business at the beginning of a taxable year and the changed business showed a net operating loss in that year, that net operating loss could be denied as a carryover to succeeding years. This result probably was not intended and is inequitable. The denial should be limited to losses which occurred prior to the change in stock ownership.

SECTION 382 (a) (4)

50. Definition of "Purchase" — B-Type Reorganization

The definition of "purchase" for the purpose of determining changes in ownership under Section 382(a) should be expanded to include acquisitions of stock for stock in B-type reorganizations.

At present, control of a loss corporation can be acquired by another corporation issuing its own stock in a reorganization that qualifies under Section 368(a)(1)(B) without becoming subject to the restrictions on use of the loss carryover contained in either Subsections (a) or (b) of Section 382. This should not be permitted, and this type of transaction should be brought within the provisions of Section 382(a).

DEFERRED COMPENSATION, ETC.

SECTION 404 (a) (5)

51. Contributions to Nonexempt Employees' Trusts

Taxpayers making contributions to a profit-sharing or pension trust not exempt under Section 401 should be allowed a deduction from net income for such payments in the year the amounts are paid to the employees by the trust even though the rights of the employees were forfeitable when the contributions were made.

An employer is allowed to deduct his contributions to an employees pension trust or annuity plan as provided in Section 404(a)(5) even if the trust to which the contributions are made has not qualified under Section 401, provided the rights of the employees under the plan are vested when the contribution is made. If the employees' rights are forfeitable, the taxpayer is not allowed a deduction in any taxable year, as provided in the Regulations Section 1.404(a)-12.

This limitation forbidding the deduction in any taxable year is inequitable. Where contributions are made to a profit-sharing or pension trust not qualified under Section 401, and the rights of the employees are forfeitable when the contributions are made, the employer should be allowed a deduction (subject to the limitations of reasonableness outlined in Section 162(a)(1)) in the year the amounts are paid to the employees by the trust.

The employees should be required to report as income only the portion of the distribution which was not previously taxed to the trust, and the employer should be allowed a deduction only for the portion of the distribution which is taxed to the employees. The procedure for the allocation should be defined in the regulations.

52. Stock Option for More than 5 Per Cent Shareholder-Employee

Options outstanding to all employees should be taken into account in determining whether an employee owns more than 5 per cent of the stock of the employer corporation for purposes of Section 422(c)(3)(C).

Section 422(c)(3)(C) provides that in determining whether or not an employee owns more than 5 per cent of the stock of the employer corporation, the stock which he may acquire by exercise of the specific option being granted is treated as owned by him.

If there are other options to other employees outstanding, the stock which may be acquired by them upon exercise of their options apparently is not considered as outstanding for purposes of determining whether or not an employee meets the 5 per cent test. There appears to be no reason why such other options should not be taken into account.

ACCOUNTING PERIODS AND METHODS

SECTIONS 452, 462

53. Taxation of Unearned Income and Allowance of Deductions for Estimated Expenses

The accounting principles originally recognized in Sections 452 and 462 of the Internal Revenue Code of 1954 should be reenacted. Section 452 related to deferral of income received for performance or delivery of service extending beyond the end of the taxable year in which such income is received. Section 462 allowed a deduction for reasonable additions to reserves for estimated expenses.

Unearned income. One of the basic principles of accounting is that income is validated by the delivery of goods or services accompanied by the receipt of cash or a claim for cash. Clearly, equity dictates that a business should not have to pay tax on money which is received but not yet earned, that is, where such receipt is burdened with an obligation to render service, etc., beyond the taxable year of the receipt. The present provisions of Section 455 dealing with prepaid subscription income and Section 456 dealing with certain prepaid dues income, although not completely adequate, do recognize this important principle.

A statutory provision should apply to receipts which carry a definite liability to furnish goods or services in the future. There should be no requirement as to any particular length of time subsequent to the end of the taxable year in which the liability to perform must be satisfied. If a maximum deferral period is considered necessary it should not be less than five years.

Taxpayers should be permitted the option of electing the deferral treatment as to classes of unearned receipts. This would permit immaterial items to be treated on a nondeferral basis.

It is recognized that an adjustment may be required during a transitional period in order to prevent substantial distortion of income.

Estimated expenses. For taxpayers on the accrual basis, another basic accounting principle concerns the matching of deductions and expenses of a fiscal period with the revenues applicable to such period even when it is necessary to estimate the amount of such deductions and expenses.

At the time Section 462 was repealed (originally enacted in the Internal Revenue Code of 1954), Congress expressed its endorsement of the basic principle of allowing taxpayers deductions for reasonable additions to reserves for estimated expenses, with adequate safeguards to prevent the possible abuses which were feared under Section 462 as originally enacted.

A new provision allowing deductions for estimated expenses should now be enacted, with the following limitations to make the provision workable and to gain additional experience with the problems that might be encountered:

1. The categories of estimated expenses for which reasonable additions to reserves would be deductible should be limited at the outset to liabilities to customers, to employees, and for multiple injury and damage claims. Provision for estimated liabilities to customers would include, for example, liabilities for cash and trade discounts, advertising allowances, allowances for defective merchandise, etc. Liabilities to employees would include, among other things, liabilities for vacation payments, workmen compensation claims, etc. Liabilities for multiple injury and damage claims should be restricted to the potential liability on an estimated basis arising out of events which happened before the close of the taxable year of the taxpayer.
2. Taxpayers should be permitted the option of electing to deduct additions to reserves for estimated expenses on an item by item basis. A requirement for an all-inclusive treatment covering every conceivable item of eligible estimated expense would carry the danger of a greater revenue impact and of attempts by taxpayers to claim deductions for items which may ultimately be held to be improper in

an effort to protect the validity of their election. An item by item election would permit taxpayers to deduct only those estimated expenses which are substantial in amount and which the taxpayers reasonably feel are contemplated within the scope of deductibility of estimated expenses.

3. In order to prevent any immediate unfavorable effect on tax revenues, a transitional adjustment may be required.

SECTION 453 (c)

54. Elimination of Double Taxation Upon Change from Accrual to Installment Basis

Upon a change from the accrual to the installment basis of reporting taxable income from installment sales by dealers in personal property, installment payments actually received during the year on account of sales made in a taxable year before the year of change should be excluded in computing taxable income for such year of change and for subsequent years.

Under the Internal Revenue Code of 1939 a taxpayer changing from the accrual method to the installment method was not permitted to exclude from gross income for the year of change and subsequent years the gross profit which had been included in income and taxed in an earlier year when the taxpayer was on the accrual basis. The result was that such taxpayer was taxed twice on the same income.

The Committee Reports accompanying the Internal Revenue Code of 1954 state that with the intention of eliminating this double taxation, Congress enacted Section 453(c) of the Internal Revenue Code of 1954. Unfortunately, that section does not go far enough for it still requires that the gross profit from installment payments received after the change to the installment method be included in gross income in the year of receipt even though it had previously been taxed under the accrual method.

Actually, Section 453(c) does not accomplish its intended purpose. Only limited relief is provided from the double tax penalty. Even if it is assumed that the tax rate and gross income is the same for the earlier year and the year of change, the net income and the final tax in the earlier year will probably have been smaller because the expenses of sale will have been deducted in the earlier year under the accrual method. Thus, the Section 453(c) adjustment will not eliminate all the tax in the second year resulting from the inclusion of the gross profit.

In order to accomplish equity between taxpayers who change from the accrual to the installment method of accounting for installment sales and taxpayers who adopted the installment method originally, and in order to bring about the expressed intent of the Congress, Section 453(c) should be amended to permit a changeover to the installment method without double taxation.

It is recognized that an adjustment will be necessary during a transitional period in order to prevent distortion of income.

SECTION 482

55. Mitigation of Statute of Limitations in Related Taxpayer Cases

Whenever the Secretary of the Treasury exercises his right to reallocate income or deductions between or among two or more taxpayers, either the party whose income is decreased or whose deductions are increased by such reallocation should be permitted to pick up the effect of the adjustment without regard to the statute of limitations, or no reallocation should be made under Section 482.

Section 482 permits the Secretary to reallocate income and deductions among related taxpayers where, in his opinion, action is necessary to reflect properly the income of the respective related taxpayers. Often, an increase in taxable income of one of the parties is determined at a time when the statute of limitations with respect to one of the related taxpayers has already expired. This bars a tax refund for such other party which otherwise would be obtainable. Thus, after having collected the tax from one taxpayer, the Secretary can refuse a refund of tax to the other taxpayer affected. In this situation the same income is taxed twice.

The party whose income is decreased or whose deductions are increased by a reallocation under Section 482 should be accorded the right of a correlative adjustment without regard to the statute of limitations. Alternatively, the Section 482 adjustment should not be permitted if the correlative adjustment is barred by the statute of limitations.

PERSONAL HOLDING COMPANY

SECTION 543 (a) (6)

56. Use of Corporate Property by Shareholder

Section 543(a)(6) should be repealed so that all rent income is treated in a consistent manner under Section 543(a)(2). Until enactment of the 1964 amendments, the section prevented the incorporation of private property to protect investment income from personal holding company penalty. The present rent section prevents any appreciable sheltering of investment income with rents from any source. Thus, the need for 543(a)(6) as a special class of personal holding company income has disappeared. Its continued existence presents difficulties and problems unrelated to the avoidance sought to be forestalled.

The original impetus for the enactment in 1937 of the predecessor to Section 543(a)(6) was that shareholders, in order to bring the percentage of investment income of their corporations below the 80 per cent personal holding company test, would transfer to a corporation a yacht, city residence or country home, and pay sufficient rent to take the corporation out of the personal holding company classification. Further, the rent paid would usually be less than the actual cost of maintaining the property and frequently less than would have been received from an outsider in a bona fide transaction. By including as a separate category of personal holding company income amounts received from shareholders for the use of corporate property, Congress eliminated this method of tax avoidance.

This provision, which was designed to reach situations in which private property was incorporated to avoid personal holding company classification, resulted in inequities where property was leased by a corporation to stockholders for use in a business operation.

Accordingly, in 1950, this section was amended to provide that rents received between 1945 and 1950 for use by the lessee in the operation of a bona fide commercial or mining enterprise should not be included in personal holding company income. In 1954, the provision was further changed so that the rent received from a shareholder was not personal holding company income if the corporation had less than 10 per cent of other personal holding company income.

During the period from 1937 to 1964, personal holding company income included rent, unless rent constituted 50 per cent or more of total gross income. However, "rent" for the purpose of this test was defined to exclude amounts received for the use of corporate property by shareholders. (Section 502(g), 1939 Code; Section 543(a)(7), 1954 Code.) Until 1964, therefore, the provision relating to a shareholder's use of property (Section 502(f), 1939 Code; Section 543(a)(6), 1954 Code) had significance in preventing tax avoidance due primarily to the rent exclusion as then defined.

Enactment of the new personal holding company provisions in 1964 changed this long standing relationship. The new section departed from the 50 per cent gross receipts test for rent and substituted a 50 per cent of "adjusted ordinary gross income" test. In computing the adjusted income from rents for purposes of this test, gross rents are reduced by depreciation, interest, taxes and rent paid on the rental property. The new law included an additional test which requires other personal holding company income to be negligible or distributed as dividends. The only pertinent change made in respect to the shareholder's use of property was to apply the 10 per cent test to "ordinary gross income" instead of "gross income."

The present tests for all practical purposes require a corporation to be engaged primarily in the rental business in order to avail itself of the rental exclusion. It is practically impossible to shelter investment income in a rental corporation in any significant amount under the present law.

The Internal Revenue Code then has come full circle in respect to a shareholder's use of corporate property. Prior to the enactment of this section in 1937, investment income could be sheltered by placing personal property in corporate form. From 1937 to 1964, it could be sheltered only by other rental property. Now, for all practical purposes, no rental property can shelter other investment income. The need for this special definition has now disappeared.

The 10 per cent test under the present rent Section (543(a)(2)) is the same as applied in the shareholder's use of corporate property Section (543(a)(6)), except that, in the latter case, investment income cannot be reduced by the dividends paid. This difference in treatment seems illogical since the abuse sought to be forestalled is the same in both cases.

Elimination of an unneeded special definition from an already extremely difficult statute and its integration with the general rent definition would be helpful. In addition, it would eliminate problems of the type highlighted by Revenue Ruling 65-259 (1965-2 CB 174). The Service's attempt in this ruling to expand the definition of rents received from shareholders seems unnecessary if its objective is to prevent sheltering of investment income, but it seems to represent an effort to force more corporations, regardless of their activity, into the personal holding company net. The intent of Section 543(a)(6) when enacted and as subsequently amended clearly indicates an attempt to alleviate a specific abuse and not hamper normal commercial enterprise. The belated attempt to extend the definition does not appear to be based on these precepts.

The personal holding company provisions should be considered apart from other abuses which can arise due to control of corporations.

ESTATES, TRUSTS, BENEFICIARIES AND DECEDENTS

SECTION 642 (h)

57. Separate Shares — Partial Termination

The deduction carryover provisions of Section 642(h) should be extended to the termination of a single beneficiary's entire interest in a trust having different beneficiaries where such interest represents a separate share as determined under Section 663(c).

The deduction carryover provision of Section 642(h) applies only upon the final termination of an estate or trust. The provision should be extended so as to include an apportionment of such deductions when there is a final termination as to a single beneficiary's separate share in a trust where there are several beneficiaries.

SECTION
643 (a)

58. Distributable Net Income

Only the excess of corpus deductions over corpus "income" should be deductible in computing distributable net income.

A limiting factor in the amount of estate and trust income taxable to the income beneficiary is "distributable net income" as defined in Section 643(a). The effect of this definition is that all items of deductions (whether charged to corpus or to income) other than the personal exemption are deductible in computing distributable net income.

Thus, for example, the income taxable to the beneficiary of a simple trust (which requires that all income—as distinguished from corpus—be distributed currently), using the following assumed annual income and deductions, would be computed as follows:

Dividends and interest income (credited to income for trust accounting purposes)	$5,000
Short-term capital gain (credited to corpus for accounting purposes)	1,000
Gross income	$6,000
Deductions:	
Legal expenses (charged to corpus)	500
Taxable income before deduction for distributions to beneficiary	$5,500

Under Section 643(a) the deduction for distributions to beneficiaries is limited to $4,500 (the $5,000 dividend and interest income, less the $500 legal expenses paid) and this is the only amount the income beneficiary would be taxed on, even though he was paid $5,000, the full annual income for trust accounting purposes.

It can thus be seen that expenses paid which are charged to corpus for estate and trust accounting purposes normally reduce the amount of income taxable to the *income* beneficiaries. This is true even though corpus may be taxed in full on such items as capital gains. In the above example, the entire $1,000 capital gain realized by *corpus* would be taxed (subject to allowance of the deduction for the trust's personal exemption) even though the $500 legal expenses had been paid by *corpus* during the year.

It is recommended that the definition of "distributable net income" be amended so that corpus deductions first be used to offset items of income taxable to corpus; only the excess should be deductible in computing distributable net income which is a measure of the amounts taxable to the income beneficiaries.

SECTION 663

59. Separate Shares—Estates

The separate shares rule should be extended to apply to estates as well as trusts when the estate has more than one beneficiary and the beneficiaries have substantially separate and independent shares in the assets of the estate.

Where any beneficiary of a trust having more than one beneficiary has a substantially separate share in the trust, each such beneficiary's share will be regarded as a separate trust for the purposes of determining the amount of income distributable to the beneficiary. As presently constituted, this provision applies only to trusts. This should be extended also to estates.

SECTION 663 (a)

60. Corpus Distributions

The definition of the types of gifts and bequests which are excluded from the gross income of beneficiaries of estates and trusts should be liberalized.

Payments of certain specific bequests or gifts of specific sums of money or specific property are not deductible from distributable net income of the estate or trust. Such payments are not includable in the income of the recipient. However, other distributions of the same nature and character result in a distribution of taxable income, and are taxed to the recipient, because they fail to meet the test of the exclusion in the Code. The Section 663 exclusion test should be liberalized to permit exclusion from income of a beneficiary of:

1. All bequests or gifts, unless payable solely from income, if paid

all at once or within one taxable year of the estate or trust, or, in the case of installment payments, if distributed before the close of the thirty-sixth month after the death of the testator.

2. Any real property, tangible personal property (except money) or stock in a closely held corporation which is properly distributed within the thirty-six months following the death of the decedent.

SECTION 691

61. Income in Respect of Decedents

The income tax deduction for the estate tax attributable to income in respect of a decedent should be replaced by an estate tax credit for the income tax attributable to such income.

The purpose of the Section 691(c) deduction is to relieve a double tax situation and place the decedent's estate or heir in the same position as the decedent would have been had he realized the income during lifetime and paid the income tax thereon. Present law provides for a deduction of an attributable portion of estate tax as an income tax deduction rather than an attributable portion of income tax as a deduction, or credit for estate tax purposes. The provision of a deduction for income tax purposes, rather than an income tax deduction or credit for estate tax purposes, appears to have been made for administrative expediency; it results in difficult and complicated computations, and can produce inequitable results.

It is recommended that the deduction permitted by Section 691(c) to persons who include in gross income, income in respect of a decedent under Section 691(a), should be replaced by rules which would permit a credit for estate tax based upon the amount of income tax which would be deemed attributable to all items includable as income in respect of a decedent under Section 691(a), less deductions allowed under Section 691(b).

REAL ESTATE INVESTMENT TRUSTS

SECTION
857 (a) (1)

62. Deficiency Dividends for Real Estate Investment Trusts

Where a real estate investment trust has acted in good faith in distributing 90 per cent of its taxable income, the dividends paid deduction also should take into account deficiency dividends, similar to those determined under Section 547, if the taxpayer's taxable income is increased upon examination so that the 90 per cent requirement is not met.

Section 857(a) provides that a real estate investment trust must distribute 90 per cent of its taxable income in dividends. It is possible that an examination by the Internal Revenue Service may change the taxpayer's taxable income significantly, resulting in a tax liability because, as a result of the increase in taxable income, the taxpayer does not meet the 90 per cent requirement.

The provisions, such as those of Section 547, regarding deduction for deficiency dividends, should be made applicable with respect to situations in which an IRS examination causes a real estate investment trust to fall below the 90 per cent requirement when prior to the examination the trust had, in good faith, distributed 90 per cent of its taxable income.

TAX BASED ON FOREIGN INCOME, ETC.

SECTIONS 862, 904, 911

63. U.S. Partners Stationed Abroad

In cases where a U.S. citizen who is a member of a partnership is stationed abroad, his entire distributive share should be treated as "income from sources without the United States" for purposes of Sections *862*, *904* and *911*.

Section 911 provides for the exemption from U.S. taxation of up to $20,000 per year (in some cases $25,000) of amounts received as compensation for personal services actually rendered by U.S. citizens under specified circumstances involving either bona fide residence or extended presence in a foreign country. There is nothing in the legislative history of this section which reveals a purpose to discriminate between partners and employees as such. Yet the developing case law (e.g., *Foster* v. *U.S.*, 329 F. 2d, 717, and *Foster*, 42 T.C. 974) has created such discrimination both through strict application of the "conduit" theory in determining the source of a partner's distributive share and through strict interpretation of the limiting language contained in Section 707(c).

When a U.S. enterprise expands abroad, it frequently will experience a period of little or no profits from such foreign operations until it becomes established. If the enterprise is conducted in corporate form, the employees of its foreign branch are eligible for the benefits of Section 911 and will not be subject to double taxation after the application of Section 901. If the enterprise is conducted in partnership form, its employees will receive the same equitable treatment, but its partners residing abroad not only are denied any exclusion under Section 911 but also must pay a double tax on their income. The country of residence imposes a tax because of the fact of residence; the U.S. imposes a tax because the distributive share of partnership income is deemed to have a U.S. source, and no foreign tax credit is available because the partner is deemed to have no foreign source income. If the foreign country does not have a tax treaty with the United States, as is generally the case in Latin America, there presently is no escape from the inequity of double taxation. Relief is speculative even in the case of treaty countries, since it depends upon recourse to the "competent authorities" and upon their amicable resolution of the problem.

There is no justification for different tax treatment of income earned from the performance of personal services abroad depending solely upon whether the individual is a corporate employee or a partner.

To remedy this condition, the distributive share of a U.S. partner who otherwise meets the requirements of either Section 911(a)(1) or 911 (a)(2) should be treated as "income from sources without the United States" for purposes of Sections 862, 904 and 911.

An alternative solution would involve amending Section 707(c) to provide that guaranteed payments to a partner for services shall be considered as made to one who is not a member of the partnership, not only for purposes of Section 61(a) and Section 162(a) as presently provided, but also for purposes of Sections 862, 904 and 911.

SECTION 902 (b)

64. Deemed Foreign Tax Credit

The deemed foreign tax credit should be liberalized by (1) permitting the credit with respect to foreign corporations lower than the second-tier, and (2) lowering the 50 per cent ownership requirement for any lower tier corporation to 25 per cent, but with the requirement that the domestic corporate shareholder have at least a 5 per cent ultimate beneficial ownership of voting stock in any lower tier corporation.

A U.S. corporate shareholder may claim a deemed foreign tax credit in the situation where it owns 10 per cent of the voting stock of a first-tier foreign corporation and the first-tier corporation owns at least 50 per cent of the voting stock of a second-tier foreign corporation.

Credits from tiers lower than the second are now not considered regardless of the degree of ownership.

Because of the business conditions that exist today it is necessary in many cases to have local nationals own more than 50 per cent of the stock of foreign corporations. Furthermore, the corporate structures of foreign investments are becoming increasingly complex as the result of such factors as circumstances existing at the time of acquisition and specialized business arrangements. In situations such as these, it seems unfair that the U.S. corporate shareholder should lose the foreign tax credit.

To remedy this condition, it is suggested that the deemed foreign tax credit should be permitted with respect to any lower tier foreign corporation which has at least 25 per cent of its voting stock held by a corporation in the tier above it.

It is recognized that this proposed rule could, as the result of numerous successive tiers, result in a deemed foreign tax credit in a situation where the ultimate beneficial ownership by the U.S. corporate shareholder is insignificant. To avoid this possibility, there should be a requirement that the U.S. corporate shareholder have at least a 5 per cent ultimate beneficial ownership of voting stock in any lower tier corporation. This 5 per cent is the same as the minimum ultimate beneficial ownership which is required under present law with respect to a second-tier subsidiary (10 per cent of 50 per cent).

SECTION 904

65. Foreign Tax Credit: Net Long-Term Capital Gains

Net long-term capital gains should be reduced in determining the limitation on foreign tax credit.

The intent of Section 1201 regarding the alternative tax on corporations realizing net long-term capital gains is to tax such net long-term capital gains at a rate of 25 per cent. However, if a U.S. corporation realizes a net long-term capital gain in the United States, the inclusion of income taxed at a rate lower than the regular corporate rate will reduce the limiting factor used in the foreign tax credit computation, thereby reducing the amount of foreign tax credit otherwise available. In substance, this amounts to an increase in the effective rate of tax on the net long-term capital gain.

Similarly, if a domestic corporation realizes a net long-term capital gain through a branch outside the United States, there will be many instances in which the inclusion of such net long-term capital gain in both the numerator and denominator of the limiting fraction will result in an excessive amount of foreign tax credit, so that the effective tax rate on the net long-term capital gain will be less than 25 per cent.

Accordingly, it is suggested that Sections 904(a)(1) and 904(a)(2) be amended so as to provide a slightly different limitation formula with respect to those corporations whose U.S. tax is computed under the alternative method of Section 1201(a).

The revised language would provide that taxable income for the purpose of the limitation should be reduced by an amount determined by multiplying the net long-term capital gain by a fraction, the numerator of which is 23 per cent, and the denominator of which is that percentage which equals the sum of the normal tax rate and the surtax rate for the taxable year (48 per cent).

SECTION 904 (b)

66. Revocation of Election of Overall Limitation

A taxpayer should have the right to an annual election to use the overall limitation or the per-country limitation on the foreign tax credit. In addition, a change in the original election should be permitted at any time within the statutory period of limitations applicable to the taxable year of such election.

Section 904, allowing a taxpayer to elect an overall limitation effective with any taxable year beginning after December 31, 1960, was added by P.L. 86-780. Once a taxpayer has made an election to use the overall limitation, that election is binding in all subsequent years, except that it may be revoked with the consent of the Commissioner of Internal Revenue. There is one exception. For the first year following a per-country limitation year, the taxpayer may elect the overall limitation or may revoke an election to use the overall limitation made in a return already filed for that year, if such election or revocation (as the case may be) is made before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed for such taxable year.

The election of the overall limitation or the per-country limitation on the use of the foreign tax credit is not a method of accounting but rather a means of computing tax liability. Since a method of accounting is not involved, there is no reason to require the consent of the Commissioner before a change in the election may be made. There are a number of reasons why a change may be necessary after the original election is made; for example, where substantial losses are realized with respect to existing investments because of nationalization, expropriation or war or where a taxpayer expects to enter substantial operations in a new foreign country and anticipates such operations will result in a loss for a number of years.

In the interest of equity and simplicity, it seems preferable that taxpayers be given the right to an annual election to use the overall limitation or the per-country limitation on the foreign tax credit. A change in the original election should be permitted at any time within the statutory period of limitations applicable to the taxable year of the original election, without first securing the consent of the Commissioner.

SECTION 904 (d)

67. Carryback and Carryover of Excess Tax Paid

The definition of the amount of the carryback and carryover of foreign tax credit should be changed so that the amount involved is the difference between the foreign tax paid or accrued and the foreign tax used as a credit. As presently defined the amount involved is the difference between the foreign tax paid or accrued and the applicable limitation under Section 904(a).

Due to the formula provided in Section 904(d) for the determination of the amount of foreign taxes paid or deemed to have been paid which can be used as a carryback or carryover, taxable income derived from two or more foreign countries can be subjected to double taxation. This will occur when the taxpayer has a loss from U.S. operations and uses the per-country foreign tax credit limitation. It does not occur when the overall limitation is used. Such double taxation results from a portion of the foreign taxes not being available for use either as a current credit or a carryback-carryover credit.

In the following example the foreign source income as reduced by the U.S. loss is taxed at an effective rate of 64 per cent. This would not occur if the amount of an unused foreign tax credit available as a carryback or carryover was defined to be the difference between the foreign tax paid or accrued and the foreign tax used as a credit.

		Income (Loss)	U.S. Tax	Foreign Tax
Foreign Country A		$100		$ 60
Foreign Country B		100		55
U.S.		(50)		
Total foreign tax				$115
Total income per U.S. return		$150		
U.S. tax @ 48% before foreign tax credit			$72	
Foreign tax credit per country limitation ($)—				
Country A: $\frac{100}{150} \times 72 =$	48			
Country B: $\frac{100}{150} \times 72 =$	48			
Credit limitation	96			
Foreign tax credit (lesser of $72 or $96)			72	72
U.S. tax payable			$ 0	
Unused foreign tax				$ 43
Available credit carryback—carryover under Section 904(d)—				
Country A ($60 − $48)				$ 12
Country B ($55 − $48)				7
Total available				$ 19
Erosion of unused foreign taxes available for foreign tax credit ($43.00 − $19.00)				$ 24
Effective combined tax rate on net taxable income of $150 (U. S. tax of $72 plus eroded foreign taxes of $24 = $96 ÷ $150) (or U. S. tax rate of 48% plus rate of unavailable foreign taxes of 16% ($24 ÷ $150))				64%

SECTION 904 (d)

68. Carryback of Excess Foreign Taxes

The two-year carryback of the excess of foreign income, etc., taxes paid over the applicable limitations in Section 904 should be changed to three years.

Section 904(d) provides that any excess of foreign income, etc., taxes paid over the applicable limitations contained in other parts of Section 904 is carried back two years and then forward five years.

The carryback and carryover principle is employed in other parts of the Internal Revenue Code. Widespread application occurs in the areas of the net operating loss and the unused investment credit. In both of these situations, a nine-year business cycle has been deemed by Congress to be most appropriate (i.e., the taxable year, three years back and five years forward). It appears that the same nine-year cycle would also be most appropriate in connection with excess foreign income taxes. Such conformity would be achieved by changing the foreign tax carryback from two years to three.

GAIN OR LOSS ON DISPOSITION OF PROPERTY

SECTION 1091

69. Wash Sales

The wash-sale provision should apply to security traders (but not to dealers) whether or not incorporated.

Section 1091, as presently written, disallows wash-sale losses incurred by taxpayers other than corporations only if such losses would be deductible under Section 165(c)(2). Section 165(c)(2) provides for the deductibility of "losses incurred in any transaction entered into for profit, though not connected with a trade or business." It is clear that, for such taxpayers, security losses incurred in a trade or business, deductible under Section 165(c)(1), are not affected by the wash-sale rule.

It has been held that taxpayers whose business it is to buy and sell securities for a speculative profit may deduct their losses under Section 165(c)(1) and are, therefore, exempt from Section 1091. Such taxpayers are called traders and are to be distinguished from security dealers who maintain an inventory and sell to customers in the ordinary course of their trade or business. Traders, although holding their securities for sale, are not merchants and may not inventory their positions because they sell them through brokers and not to customers (Regulations Section 1.471-5). It is also pertinent to note that, in the case of corporations, Section 1091 is operative except as to losses incurred in the ordinary course of the business of a corporate security dealer.

The special treatment given to noncorporate traders is not warranted and gives such taxpayers an unfair advantage over noncorporate investors and over corporations active in the purchase and sale of securities. Even though this exemption is of long standing, a persuasive case can be made for the position that it arose in the first place as a result of a misunderstanding. For a complete discussion of the background of this section, see S. Walter Shine, "Wash-Sale Losses—A Gift to Security 'Traders,'" *Taxes,* June 1954, p. 455. The article indicates that the original intention was to limit the exemption to dealers because they could inventory their positions. Since dealers may, under an appropriate inventory method, avail themselves of unrealized losses in their inventory, the application of the wash-sale rule to them is unnecessary. This interpretation of the original intent is logical, while the extension of the exemption to traders who may not inventory their positions is not. Furthermore, the distinction between corporate and noncorporate traders is similarly illogical and casts doubt upon the correctness of the latter's exemption.

It should also be noted that the factual determination of who is or is not a trader has caused considerable difficulty at administrative levels of the Internal Revenue Service. Inequitable decisions are bound to occur because of the problem of determining whether or not a particular taxpayer's buying and selling activities are sufficient to constitute the carrying out of a trade or business. This administrative burden, with necessarily varying results among taxpayers in borderline cases, is not warranted in administering a law that appears to be illogical. For these reasons, Section 1091 should be amended so that it is applicable to all taxpayers except with respect to transactions in the ordinary course of the trade or business of security dealers.

CAPITAL GAINS AND LOSSES

SECTION 1201

70. Capital Gains: Alternative Tax

The alternative tax should not be in excess of 25 per cent of the amount of the net taxable income when such net income is attributable to net long-term capital gains.

The tax for an individual or corporation having an excess of ordinary deductions over ordinary income, that is, an ordinary loss, and a net long-term capital gain in excess of such ordinary loss, is the lesser of:

1. The tax computed by applying the regular rates to the taxable income (net long-term capital gain reduced by the ordinary loss); or
2. The alternative tax, which is 25 per cent of the net long-term capital gain.

Irrespective of which calculation provides the lower tax, the ordinary loss is absorbed by the net long-term capital gain. In some instances, under these circumstances, the taxpayer receives no benefit from the ordinary loss.

The following example illustrates the point:

A corporation has net taxable income of $75,000 for 1966 comprised of a long-term capital gain of $100,000 minus an ordinary loss of $25,000. Its tax is $25,000, that is, the lesser of the alternative tax of 25 per cent on the entire long-term capital gain and the tax computed at the regular rates on its net taxable income, $29,500. If the corporation had broken even on its ordinary operations, its tax would still have been $25,000. In effect, therefore, it receives no tax benefit from its operating loss of $25,000.

The 25 per cent maximum alternative tax should be applied to net taxable income if such income is less than the net long-term gain. In the example, the tax would be only 25 per cent of $75,000 or $18,750.

SECTION
1232

71. Capital Loss Treatment of Bad Debts

Section 1232 should be amended to exclude any loss resulting from partial uncollectibility of an advance to a company which is an affiliate as defined in Section 165(g)(3).

Section 1232 provides for capital gain or loss treatment on the retirement of indebtedness issued by any corporation or government or political subdivision thereof. Under the 1939 Code, the treatment was limited to indebtedness issued with interest coupons or in registered form. The 1954 Code dropped this requirement and extended the capital gain or loss treatment to all corporate and government "bonds, debentures, notes, or certificates or other evidences of indebtedness" issued on or after January 1, 1955, which are capital assets to the taxpayer.

Because of the 1954 change, certain items that could previously be deducted as bad debts under Section 166 may now be capital losses under Section 1232. For example, if Corporation A, for good business reasons, makes a loan to Corporation B, which is evidenced by a note, and Corporation B is subsequently able to repay only a portion of the loan, Corporation A might have a capital loss on the retirement of the indebtedness (assuming that the note is a capital asset in the hands of A). Although the Committee Reports on the 1954 Code give no indication one way or the other, it seems unlikely that this result was intended in the case of affiliated corporations. Therefore, Section 1232 should be made inapplicable to loans to affiliates, as defined in Section 165(g)(3), which otherwise would qualify as business bad debts under Section 166.

READADJUSTMENT OF TAX BETWEEN YEARS AND SPECIAL LIMITATIONS

SECTION 1321

72. Involuntary Liquidation of Lifo Inventory

Rules regarding involuntary liquidation of Lifo inventories should be permanently extended to cover all conditions and circumstances beyond the reasonable control of the taxpayer which, directly or indirectly, prevent the acquisition of inventory.

The Lifo inventory method is based on the realistic business fact that a going business must maintain a "fixed" minimum inventory position in order to continue functioning effectively. Based on this assumption, Congress has provided special rules covering Lifo inventories involuntarily liquidated during wartime and similar emergency periods. In these circumstances, the liquidation must have been the result of the prevailing emergency conditions in order to invoke the special rules providing for replacement of the liquidated Lifo inventory at a tax cost basis equivalent to that of the inventory formerly held.

Similar conditions completely beyond the reasonable control of the taxpayer may exist in periods other than those of national emergency which may effectively prevent maintenance of the normally required inventory by a particular taxpayer. Such conditions, for example, might include events such as fires and floods, as well as economic happenings such as strikes, peculiar to the particular taxpayer.

In view of this, the Code should be amended to provide permanent rules covering the involuntary liquidation of Lifo inventory caused by circumstances and conditions beyond the reasonable control of a taxpayer. Sufficient safeguards should be enacted to make certain that the liquidation is the result of such circumstance or condition, and that it is not simply a coincidental event.

ELECTION OF CERTAIN SMALL BUSINESS CORPORATIONS AS TO TAXABLE STATUS

SECTION 1376 (a)

73. Increase in Basis of Indebtedness to a Shareholder

The undistributed taxable income of an electing small business corporation which is taxed as a dividend to a shareholder should be used first to restore the basis of the shareholder's advances to the corporation where such basis has been previously reduced by his portion of net operating losses.

Under Section 1376(b), net operating losses of an electing small business corporation which are allowed to its shareholders under Section 1374 are used first to reduce the basis of a shareholder's stock. If the basis of any shareholder's stock is thereby reduced to zero, any excess loss is used to reduce the basis of indebtedness to the shareholders.

Section 1376(a) provides that any amount which is required to be included in the gross income of a shareholder under Section 1373(b) is added only to the basis of the shareholder's stock.

These two rules may operate unfairly for a shareholder. Assume, for example, that a sole shareholder has invested $10,000 in the stock of an electing small business corporation and has made advances on open account of $15,000. Losses in the initial years of the business total $15,000, but thereafter the corporation turns profitable and proceeds to earn $15,000 in its first year of profitable operations. At this point, the basis of his stock will be $15,000 ($10,000 original cost, less $10,000 reduction, plus $15,000 income); the basis of his $15,000 face amount receivable on advances will be $10,000 ($15,000 original basis, less $5,000 reduction, with no restoration). Economically, the sole stockholder is back at the starting point. However, in these circumstances he cannot collect his advances in full without realizing taxable income of $5,000, represented by the excess of the face amount repaid over his basis. Equity demands that additions to basis should first be applied to restore the amount of basis which was reduced by prior losses.

SECTIONS
1376 (b)
1251

74. Gain from Recovery of Reduction of Basis of Indebtedness Under Section 1376(b)

Any gain by the shareholder of an electing small business corporation on the subsequent collection or sale of the corporation's indebtedness to him should be taxed as ordinary income to the extent the basis of the indebtedness has been reduced by the shareholder's portion of net operating losses.

A shareholder of an electing small business corporation reports his portion of the corporation's net operating loss as an ordinary deduction. If the adjusted basis of his stock has been reduced to zero, there will then be a reduction in the basis of any indebtedness which the corporation owes him. If the indebtedness is subsequently sold or collected at a gain, the shareholder realizes long-term capital gain if the indebtedness is a capital asset in his hands. (See Revenue Ruling 64-162 (1964-1 CB 304) to this effect.) (Under Section 1232 amounts received on the retirement of corporate indebtedness evidenced by bonds, debentures, notes, certificates, etc., are considered as amounts received in exchange thereof.)

Equity seems to require that the ordinary loss taken by the shareholder should result in treatment as ordinary income of any gain attributable to recovery of this reduction of basis.

ESTATE AND GIFT TAXES

SECTION
2014 (b)

75. Credit for Foreign Death Taxes

The limitation on the amount of foreign death taxes creditable against Federal estate tax should, at the option of the taxpayer, be determined on an overall basis.

Section 18 of the Revenue Act of 1962 amended prior law to eliminate the exclusion from the gross estate of real property situated outside of the United States. This increase in the ambit of Federal estate taxation focuses attention on the goal of avoiding double taxation of estates.

The amount of foreign death taxes creditable against Federal estate tax is the lesser of two amounts under limitations computed on a per-country basis. In 1960 Congress amended the foreign income tax credit provision in order to give taxpayers an election to compute that credit on either a per-country basis or an overall basis. The same election should be available to fiduciaries of estates with assets in more than one foreign country.

SECTIONS
2031
2032
2512 (a)

76. Valuation of Property for Estate and Gift Tax

The value of property for estate and gift tax purposes should never be greater than the amount that could in fact be realized by the donor or decedent's estate.

The Internal Revenue Code bases the gift tax on the value of the gift. This has been defined in the regulations as the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts.

The regulations now provide that for gift tax purposes (as well as for estate tax purposes) shares of an open-end investment company (mutual fund) are to be valued at the *public offering price* (asked price), which generally includes a loading charge. This is unreasonable. The valuation should be based on the *redemption price* (bid price) quoted for such shares by the company, which is all the donor (or the executor) could realize on disposal.

The Treasury has also amended the Gift Tax Regulations (and the Estate Tax Regulations) in regard to the definition of the value of gifts of property if the item of property is generally obtained by the public in the retail market. The fair market value is then the price at which the item or a comparable item would be sold at retail. This provision is inequitable for the same reason cited for mutual fund shares in that it could impose a higher valuation for gift and estate tax purposes than could be realized by the donor (or the decedent's estate).

It is recommended that the provisions of Section 2031, 2032 and 2512(a) be clarified to provide that in no instance could the value of property subject to estate or gift tax be greater than the amount that could in fact be realized by the donor or decedent's estate.

SECTION 2042

77. Reversionary Interests — Insurance

The provisions relating to the 5 per cent reversionary interest should be limited to those situations where the decedent retained a reversionary interest. Any interest that arises through inheritance or operation of law should be excluded from applicability.

Present law provides for the inclusion of the value of insurance receivable by beneficiaries other than the executor in the gross estate of the decedent where the decedent had any of the incidents of ownership in the policy. "Incident of ownership" includes a reversionary interest if its value is more than 5 per cent of the value of the policy immediately before death. In determining the value of the reversionary interest, the possibility that the policy or its proceeds may revert to the decedent by reason of operation of law should not be considered since the decedent would have no control over this factor.

SECTION 2503 (c)

78. Exclusion for Gifts of Certain Future Interests

The annual $3,000 gift tax exclusion should be extended to all gifts of future interest where the property will be used solely for the benefit of a specified donee during his life and the remainder of the property, if any, will on his death be included in his gross estate.

Section 2503(c) provides the conditions under which a transfer for the benefit of a donee under age 21 on the date of the gift will not be considered a gift of a future interest in property, and for which, therefore, the annual $3,000 gift tax exclusion will be allowed. Basically, these conditions are that the corpus of the gift, together with any undistributed income, be completely distributed to the donee at age 21. Criticism of Section 2503(c) has been directed mainly to its requirement for complete distribution of corpus.

It is proposed that while no change be made in the requirement of Section 2503(c) that accumulated income is paid to the minor at age 21, it be amended to permit corpus to be retained in the trust, providing that income must be distributed currently to the beneficiary after age 21 and that the beneficiary has a general power of appointment over such corpus after age 21. The retained corpus thus will be included in the beneficiary's gross estate on his death, eliminating any possible loss of estate tax revenue.

SECTION 2504 (c)

79. Valuation of Taxable Gifts Made in Prior Years

The prohibition of an adjustment of the value of taxable gifts made in prior years where the statute of limitations has expired should not depend on the payment of gift tax.

Section 2504(c) now provides that the value of a gift made in a prior year cannot be readjusted in subsequent years if the gift tax was actually paid on the gift made in the prior year and the period of limitations for assessment has expired for such year. This requires that *taxable* gifts (gifts in excess of the allowable exclusions and deductions) must have been made in the prior year in order for the prohibition against the adjustment in value to be applicable.

It appears illogical not to permit the same prohibition to apply where no tax was payable because the allowable exclusions and deductions equalled or exceeded the value of the annual gifts made. It, therefore, is proposed that this section be amended to apply whether or not a gift tax has been paid, provided that a gift tax return has been filed.

PROCEDURE AND ADMINISTRATION

SECTION 6081

80. Automatic Extension of Filing Time for Certain Individual Returns

A provision similar to that now available to corporations for automatic extension of time for filing corporation income tax returns should be enacted to cover certain individual and fiduciary income tax returns.

The increasing complexities of the tax laws, the greater burdens of compliance caused by the complex tax laws, expanded use of electronic data processing, and the growing problem of securing professional help have made it difficult for many taxpayers to file a professionally prepared return on a timely basis.

Senate Report No. 1622 (83rd Congress, 2nd Session) accompanying H.R. 8300 (Internal Revenue Code of 1954) states that the postponement to April 15 of the date for individuals to file their income tax returns would "greatly relieve the difficulties taxpayers now have in preparing their returns by the present filing date," (i.e., March 15). The Report also provided that the postponement ". . . should also result in the filing of more carefully prepared returns . . . and should be beneficial to those who aid taxpayers in making out their returns." Unfortunately, this was not to be the result.

All statistical information available indicates that the number of individual taxpayers who encounter some complexities in preparing their returns has increased substantially over the past few years and is expected to increase at an even more rapid rate in the future.

The time required for the preparation of a personal income tax return increases year by year. Present returns require details of dividend and interest income; there are now special forms for such items as exclusion of sick pay, employee business expenses, moving expenses, etc.; if there is an indicated underestimation of tax, Form 2210 should be attached; if income averaging is applicable, additional computations and schedules are required; the instructions call for substantial data in support of deductions for contributions in property.

With the expanded use of ADP by the Service, taxpayers are very anxious, and properly so, that amounts reported on all types of information returns agree precisely with amounts reflected in their returns. However, since Forms W-2 and 1099 are not required to be furnished to taxpayers until the end of January, the period in which returns must be prepared is significantly shortened.

Under Section 6081(a), the Secretary or his delegate *may* grant a reasonable extension of time for the filing of an individual income tax return. Regulations Section 1.6081(b) provides that a taxpayer must submit an application for such extension containing, among other things, "a full recital of the reason for requesting the extension." The Service must then determine whether the cited reasons merit the granting of the extension requested.

The Internal Revenue Service has co-operated to the extent possible, administratively, to assist taxpayers by providing a policy for handling requests for extensions of time for filing individual returns. This administrative policy, while helpful, is still inadequate.

The majority of cases where extensions are needed for filing individual returns are those involving income from the operation of a trade or business, income from farming, income from business partnerships, joint ventures, pools or syndicates, and income from electing small business corporations (Subchapter S corporations). Similar problems may affect income tax returns filed by estates and trusts. The filing problems arising in these situations frequently are more acute than those affecting many corporations.

Section 6081(b) added to the Internal Revenue Code in 1954 provides for an automatic three-month extension of time for the filing of a corporate income tax return, merely upon application on a prescribed form (Form 7004) properly executed, timely filed, and accompanied by a remittance of estimated tax as prescribed in Regulations Section 1.6081-3(a)(2).

The existing situation with respect to certain individual and fiduciary returns can only be remedied adequately by legislation similar to that enacted in 1954 regarding automatic extensions of time for filing corporate income tax returns.

Provision for a two-month extension for the individual returns noted above involving business income would be contingent upon the filing of an application on a form comparable to Form 7004 accompanied by a remittance of the full amount of tax estimated to be due (except for returns filed by estates where present law permits quarterly payment of tax).

SECTION 6511 (d) (2)

81. Statute of Limitations on Refunds Arising From Net Operating Loss Carrybacks

Claim for refund with respect to a net operating loss carryback should be timely if filed within three years from the due date, *including extensions*, of the return for the loss year.

If a taxpayer secures an extension for filing the tax return for a loss year, the statute of limitations on assessment will be extended to three years following the extended due date. Under Section 6511(d)(2), however, claim for refund based on carryback of the net operating loss must be made not later than three years following the *original* due date of the return for the loss year. Thus a gap is created during which assessment may be permitted but adjustments giving rise to additional refunds are barred.

This gap should be eliminated by providing that a refund claim based on a net operating loss carryback will be timely if filed not later than the expiration of the statute of limitations for assessment of tax with respect to the loss year.

SECTION 6601

82. Interest on an Underpayment on Form 7004

It should be made clear that, where a corporation has obtained an extension of time for filing its income tax return under Section 6081(b), interest will be charged on an underestimate only to the extent that the correct first installment exceeds the amount actually paid as a first installment.

A corporation is entitled to an automatic extension of time for filing its income tax return upon the filing of Form 7004 and the payment of one-half the estimated amount of its tax. Interest is quite properly charged where the corporation's estimate of its tax is less than the tax which is ultimately shown on its return. However, the amount of such interest is computed on a basis which is inequitable. The Internal Revenue Service takes the position that interest should be computed as if the Form 7004 were a final return. Thus, it computes interest on the excess of the final tax over that shown on Form 7004 just as if the Form 7004 were a return. The historical practice, before the enactment of Section 6081(b), was to charge interest only on the difference between the correct first installment and the amount paid as a first installment. This historical practice should be the present law.

The effect of the present practice is that an interest charge would be asserted under the following circumstances where no actual underpayment was involved:

Tax estimate per Form 7004	\$100,000
Installment paid with Form 7004	\$ 75,000
Tax per Form 1120 (final tax)	\$150,000

Under these circumstances, the Treasury's position is that interest should be computed for three months on \$25,000 (the difference between half the final tax and half the amount shown on the Form 7004).

SECTION 6672

83. 100 Per Cent Penalty for Failure to Collect and Pay Over Tax

The enforcement of collection of a penalty under Section 6672 should be stayed during a period of judicial review and determination if the taxpayer posts a bond equal to 150 per cent of the unpaid amount of the penalty sought to be assessed and collected.

The penalty imposed by Section 6672 applies only to the collection, accounting for, or payment over of all taxes imposed on a person other than the person who is required to collect, account for and pay over such taxes. The Secretary of the Treasury or his delegate is given the right to assess and collect such taxes without judicial review. Judicial review cannot be had until at least a partial payment is made and suit instituted for recovery of the amount so paid.

Extreme hardships could result from the application of this section.

It is possible that appreciated assets would have to be sold, resulting in the payment of income taxes on the profit, when a court might hold that there was no liability on the taxpayer for the penalty. Equity would demand that a person from whom amounts are sought to be collected under Section 6672 should have a right to post bond until such time as his liability is determined by judicial process. The posting of a bond of one and one-half times the amount of the tax would fully protect any loss of revenue which could be occasioned by delay in collection procedures.

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